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On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to the ECB Consultation its Draft Guidance on leveraged transactions

I. Introduction

The European private equity and venture capital industry welcomes the opportunity to respond to the European Central Bank (ECB) consultation on its draft guidance on leveraged transactions (the “Guidance”) and appreciates the fact that the ECB has chosen to seek feedback before its introduction.

While we welcome the ECB’s decision to provide guidance for European lenders, we do not believe that the proposed Guidance is sufficiently nuanced to appropriately monitor credit institutions’ leveraged activities and risks discriminating against private equity and venture capital financed companies, in particular when compared to the guidelines relating to leveraged lending which have been in place in the US for several years.

In this response we only focus on the definition of ‘*leveraged transactions*’ proposed by the ECB for the purpose of its guidance as it may have some important implications for the private equity and venture capital industry and particularly for companies that our industry supports. We also have strong concerns on the lack of clarity and nuance on the type of transactions that would be covered by the Guidance.

The definition of ‘*leveraged transactions*’ as currently drafted in section 3 of the Guidance encompasses two conditions, (i) the borrower’s level of leverage exceeding 4.0x Total Debt to EBITDA and (ii) the borrower’s ownership by ‘*financial sponsors*’. In view of these two conditions, the proposed definition could be very wide in scope and unintentionally capture many transactions presenting a credit risk profile that is fundamentally different and more favourable than that of other transactions that are not captured by the definition.

If this definition were to be applied by credit institutions in its current form, it could have a direct effect on banks’ strategy and their ability to lend to many companies, including those backed by private equity, venture capital and infrastructure funds, potentially depriving them of financing needed for their development. This would also compromise the ongoing efforts of the European Commission to expand sources of reliable financing in the context of the Capital Markets Union and the European Fund for Strategic Investments.

II. Comments on the ECB definition of leveraged transactions

We have three main concerns with the ECB definition of ‘*leveraged transactions*’, which are addressed in this paper and which relate to:

- a. the treatment of loans where the borrower is owned by a financial sponsor;
- b. the calculation of the post-financing level of leverage and the absence of qualitative criteria in the ECB definition of these transactions;
- c. the fact that only project loans, and not other types of infrastructure loans, are excluded from the scope of the Guidance.

A. Treatment of loans where the borrower is owned by a financial sponsor

We would like to share with the ECB our concerns with the second part of the proposed definition of ‘*leveraged transactions*’, which states that “*all types of loans or credit exposures where the borrower is owned by one or more financial sponsors*” would necessarily be deemed leveraged. ‘*Financial sponsors*’ are referred to as investment firms ‘*that undertake private equity investments in and/or leveraged buyouts of companies with the intention of exiting those investments on a medium-term basis [i.e., more than six months].*’

This definition inappropriately captures a very wide variety of financial investors, ranging from large private equity funds to venture capital and infrastructure funds, which invest in an equally wide variety of portfolio companies. There is no commonality either among such investors or among their portfolio companies that would justify their being treated in such a homogeneous manner for bank lending purposes. The reference to financial investors’ ownership of “more than six months” is also misleading.

Private equity funds provide long-term, equity-backed financing for more than 5,000 European businesses each year, 86% of which are SMEs, employing around 8 million people. The average investment period is six years. They connect providers of capital - such as pension funds, insurers and also banks - with businesses that are looking not only for equity investment but also for the strategic and operational guidance and assistance that a private equity manager can bring. In that respect, the private equity industry plays an important role in delivering smart, sustainable and inclusive growth that creates jobs and enhances long-term competitiveness.

They follow an active ownership model, actively monitoring the management and the development of the company and rendering strategic advice to it. They work, through the board, to ensure each investee company has, and improves, its own management team.

The role of the private equity investor is to draw down from a pool of committed capital to fund investments in a diverse range of portfolio companies over the course of the fund’s

investment period. As the fund realizes its investment in each portfolio company, companies are sold, typically through trade sales or IPOs, and the proceeds are promptly distributed to the investors. During the investment period, the fund manager seeks to increase the performance, quality, and value of the portfolio companies through long-term active ownership. Active ownership in the context of a private equity fund's investment typically means actively monitoring and engaging with the management of the portfolio company both in board meetings and more regularly on specific projects/issues depending on what stage the business is at in its development. This includes providing strategic advice on the development and implementation of the business strategy, recruiting key members of the management team and identifying and bringing in specialists to work with management on specific projects. All of this is aimed at helping management build a sustainable business far beyond the period in which the private equity fund is invested.

Defining lending to any company as '*leveraged*' simply because the borrower is owned by a private equity company would be particularly inappropriate in view of the average length of company holding (six years). During this period, portfolio companies commonly have occasion to seek financing from third party banks that has nothing to do with the original investment transactions. As with any type of business, these companies are quite likely to require additional financing, in order to invest in new capacity or to make add-on acquisitions.

Loans to such companies are directly equivalent to bank lending to *any* other corporate held by *any* type of owner. From the perspective of the bank, lending to a portfolio company that is backed by private equity is the same in all key respects as lending to a company with any other ownership structure. In many cases the bank will have had a long-standing relationship with the company, and the loan provision will be done irrespective of the ownership of the company at the time of the loan, whether it is in the hands of the entrepreneur, business angels, venture capital and private equity or listed on stock markets as lending is typically done based on the company's own merits and cash-generation capacity. From the bank's perspective the key consideration is first and foremost the business to which it is lending: its current state and its future outlook. To categorise all such lending as '*leveraged transactions*' simply because a borrower's controlling shareholder is a financial investor would discriminate both against private equity funds and against European companies controlled by them.

The lack of justification for treating all loans to private equity-controlled borrowers as a single category of leveraged transactions is particularly clear where the loans in question are secured by collateral, making it highly likely that the loan will be repaid. As a consequence, the risk that the loan is not repaid, which is the main risk faced by the bank, is one that the bank can consider and manage as it would with any other corporate loan.

Indeed, the draft Guidance offers no justification for treating all banks' loans and credit exposures to companies owned by private equity firms as '*leveraged transactions*'. The use of financial leverage might be a feature of a private equity deal and as a result some private equity backed companies may be deemed leveraged (as they will partially use debt in the capital structure to fund the acquisition). However, the mere fact that a portfolio company's shareholders include private equity funds does not make this company *as such* a leveraged entity. If such a company is indeed leveraged, will be captured by the first criterion of the definition which states that '*loans or credit exposures where the borrower's post financing of leverage exceeds a total debt to EBITDA ratio of 4.0 times*' are leveraged transactions¹. We also note that the US guidelines referred to above do include various criteria used to determine whether lending should be considered leveraged, but do not include any blanket assumption that lending to a borrower backed by a '*financial sponsor*' should automatically be treated as leveraged.

There is no reason to believe that loans in a private equity context are inherently riskier than similar transactions undertaken by companies backed by others. In fact, there is good evidence to suggest the opposite - that lending to a private equity-backed company might entail the same or even lower risk than equivalent lending to another company.

Indeed, the default rate for private equity-backed companies is lower than for similar publicly-owned companies². Several studies have found that private equity-backed companies generally have better corporate recovery and survival rates³. There is also significant evidence that the average default rate for private equity portfolio companies is effectively lower than the average default rate for non-private equity-backed borrowers (3.97% versus 4.62% between 1998 and 2011 in the US⁴ - in Europe, the default rate is up to 25% lower than for non-private equity backed companies⁵). Moreover, those private equity-backed companies which do default spend less time in financial distress and are more likely to survive as an independent, reorganised company than non-private equity backed companies.

¹ The fund manager will actually more than often reduce the amount of leverage in the company it invests in over time. For example, in France, the ratio of financial debt to overall EBITDA fell from 4.4x EBITDA on average at the start of the holding period by private equity buy-out managers to 2.5x EBITDA at the end of the period (Création de valeur dans les PME et ETI françaises accompagnées par les acteurs français du mid-market, October 2016, AFIC/EY)

² Study by the Bank for International Settlements (2008), looking at leveraged buyouts globally between 1997 and 2001, suggests that the failure rate for private equity-backed companies is at least 5% lower than similar publicly owned companies.

³ Cf. Frontier Economics Report, *Exploring the impact of private equity on economic growth in Europe*, May 2013.

⁴ <http://www.forbes.com/sites/janetnovack/2012/01/23/romney-private-equity-and-defaults-what-the-record-shows/#173475082377>

⁵ Kaplan and Strömberg (2009). This study was based on 3,200 businesses.

In conclusion, such a requirement, which is not justified anywhere in the Guidance, would risk having serious negative consequences for the private equity industry without any benefit to lenders. The huge variety of private equity and venture capital investments, which range from small start-ups to large and established multinationals, also makes such a one-size-fits-all approach inappropriate. The imposition of guidelines based on arbitrary ratios would be particularly harmful for European start-ups, who may have little or no EBITDA and make it more difficult for the companies that depend on venture capital investors to obtain credit.

It is also important to remind the ECB that the Alternative Investment Fund Managers Directive, which regulates all types of alternative investment fund managers, already contains asset stripping rules and reporting obligations for highly leveraged transactions. It is neither necessary nor appropriate for the ECB to introduce regulatory requirements on bank lending to companies simply because they are controlled by financial investors who are in any event already subject to extensive regulations.

B. Post financing leverage and absence of credit risk criteria

We are also concerned about the way the post-financing leverage is calculated in point (i) of the '*leveraged transactions*' definition, and do not believe that the text, as currently proposed, would capture the actual risk faced by banks. Existing EU law already provides for complex tiered risk-weighting systems, which take into account several metrics to determine the risk posed by the lending to a borrower, for banks to use in assessing credit risk.

As described in the previous section, the absolute level of leverage of a borrower is not necessarily proportional to the risk the loan poses to the bank's balance sheet. If the objective of the Guidance is to promote sound risk-management practices in banks, it should allow credit institutions to take into account the borrower's credit worthiness, including cash flows and assets, its ability to de-lever over time and market conditions when taking an investment decision that will affect its exposure - i.e. all elements that indicate the borrower's credit worthiness - rather than simply base itself on an arbitrary debt/EBITDA ratio.

In many cases the refinancing risk and the borrower's ability to deleverage over time will matter much more to the bank than the amount of leverage, which is why banks will tailor each borrower's leverage to the perceived credit risk. This is, for example, the case for companies that are financed by infrastructure funds, where the acceptable refinancing risk at maturity of a loan is generally low given that the continuing high predictability of

cash flows over the long-term ensures that the debt can be fully repaid over an acceptable period of time. In light of the above, a definition of *'leveraged transactions'*, solely based on any pre-defined debt/EBIDTA ratio, is likely to be inappropriate from a risk management perspective. For some industries characterised by high cyclicity (such as fashion retail, for example), a leverage level of 4.0x may well already be deemed as too high from a credit risk perspective, whilst for other businesses (such as infrastructure businesses), 4.0x would be more than comfortable.

The same issue relates to the ECB's suggestion that the ratio of Total Debt to EBITDA exceeding 6.0x should always remain *'exceptional'*. Provided a company has predictable and stable earnings and an underlying growth potential, and as a result a strong cash-generative capacity, the credit institution may very well decide that these transactions, although leveraged, will be able to support these high valuation multiples better than other types of companies with a lower leverage ratio. Characterising these transactions as *'exceptional'*, as proposed in the Guidance, does not recognise that there are many borrowers that can and do support leverage at higher levels than 6.0x. If a limit to the leverage ratio should be quantified at all, it should be appropriately based on facts and circumstances rather than just on an arbitrary fixed level. We recognise the US Guidelines face a similar issue in their approach in that regard.

As noted in the introduction, and irrespective of the point above, it is instructive to compare the proposed approach to the leveraged lending guidelines published in the US by the Federal Reserve Board, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency in 2013 (updating and replacing guidelines in place since 2001). Whilst the US Guidelines contain similar quantitative criteria to the Guidance relating to the EBITDA multiplier (although they differ in important aspects as demonstrated below), they contain several qualitative criteria to be used in determining whether lending should be treated as leveraged. These include:

- i) the borrower profile (whether the borrower is recognised in the debt markets as being highly leveraged); and
- ii) the industry (whether the relevant financing significantly exceeds industry norms or historic levels).

As a result, the US Guidelines do not single out any specific type of investor for discriminatory treatment and do not use a single arbitrary ratio.

Meanwhile, the ECB draft Guidance assumes that EBITDA means realized EBITDA without adjustments made for non-recurring expenses, exceptional items and other one-offs. This use of unadjusted EBITDA would not appropriately reflect that debt repayment is actually to be serviced out of future maintainable earnings.

The use of unadjusted EBITDA would in addition be punitive to borrowers investing in the future growth of their underlying business and as such of the wider economy. Capital expenditures (with the exception of maintenance capital expenditures) are typically only incurred against an investment plan put together by the borrower's management team based on reasonable assumptions and in a form coherent with the borrower's historic track record of performance. The EBITDA contribution resulting from such investments would take time to fully materialise in an unadjusted EBITDA, as it fails to not only take account of its ramping up profile but also the first few months of its full year contribution. In some industries, the EBITDA contribution from such capital expenditures will even be mostly de-risked through contractual secured revenues against such capital expenditures.

The apparent resulting re-leveraging effect, on an unadjusted basis, of such growth capital expenditures and the consequences for borrowers and lenders implied by the proposed ECB guidance could discourage (i) borrowers from investing and (ii) lenders from supporting borrower's growth initiatives that would otherwise create value for all stakeholders, lenders, shareholders and employees.

The same comment applies to growth capital expenditures incurred for the purpose of completing an acquisition, whether of another business or of operating assets, by the borrower. The EBITDA should be adjusted for the full year contribution from such acquisitions. Adjustments for cost synergies would also be typical and justifiable in view of their degree of certainty when deriving a relevant leverage measure against maintainable earnings and cash flows.

It is worthwhile to note that the draft Guidance does not specify whether a gross or net measure (i.e. respectively excluding or including a borrower's cash position) should be applied in determining total debt, something that could make a significant difference in the way a bank would calculate the post-financing level of leverage of a borrower. We note that a leverage measure calculated on a net basis is most appropriate when assessing any borrower's credit risk.

Finally, aligning European and US guidelines could also avoid potentially anomalous situations where European regulated banks would be at a disadvantage compared to US regulated lenders. Companies backed by private equity firms are financed by credit institutions on both sides of the Atlantic and a level playing field would help maximising financing competition and liquidity.

C. Treatment of infrastructure funds: only project loans are excluded from scope of Guidance

Whilst the draft definition of '*leveraged transactions*' fails to link the qualification of a transaction as a leveraged transaction to each borrower and/or credit instrument's underlying credit risk it does helpfully exclude certain categories of transactions from the scope of the definition. Such categories of transactions are essentially characterised by their stronger credit risk profile (in reference to items (iv) commercial real estate financing, (v) project finance loans and (vi) trade finance).

Unfortunately, infrastructure transactions other than project loans are not specifically excluded from the proposed definition. This is despite the fact that these transactions are characterised by the same features and the same borrower's credit risk profile as project loans. There is therefore no justifiable reason to differentiate between infrastructure investments in the construction and in the operational phase.

Operating entities are as essential to the provision of infrastructure as project entities and make equivalent contributions to the delivery of a service to end-users as investment in the construction of (new) physical assets. Without effective and efficient operation, an infrastructure asset will fail to deliver the economic benefits that it is designed to produce over the long term. For that reason, infrastructure should be seen in its broader context, and loans to operating companies should receive the same regulatory treatment as project loans.

Moreover, brownfield and corporate transactions play an important role in the ability of borrowers and credit institutions alike to recycle some of the capital otherwise committed to transactions currently already excluded from the definition of '*leveraged transactions*', for example under point (v) project finance loans. The role of brownfield and corporate infrastructure transactions is essential to the freeing up of capital required to finance new greenfield developments of what will be the infrastructure of tomorrow.

As already explained in section (B), it is also worth noting here that long-term business stability and solid recurring long-term cash flow generation and, as a result, the ability of the borrowers to support their debt are among the key features of infrastructure borrowers, whether in the context of a greenfield or a brownfield transaction. As such, all these borrowers are typically able to support leverage levels exceeding the proposed 4.0x limit of the draft definition (as well as potentially the 6.0x '*exceptional*' leverage level proposed in the Guidance) whilst maintaining a very favourable credit risk profile that would be superior to that of other non-infrastructure leveraged transactions.

Overall, long-term business stability and solid recurring long-term cash flow generation mitigate refinancing considerations in the short to mid-term and as such do not warrant the stated requirement in the Guidance for the borrower to repay at least half its debt within 5-7 years.

Based on the above considerations and so as to recognise the different nature of infrastructure borrowers, we propose the definition of '*leveraged transactions*' be adjusted to also exclude all infrastructure transactions and portfolio companies owned by infrastructure funds, and not just those that relate to pure project finance.

III. Conclusion

We are concerned that the ECB proposed approach to the treatment of banks' lending to companies in which private equity funds have controlling ownership has not been appropriately assessed and analysed. If the draft Guidance is implemented as now proposed, there is a meaningful risk of a negative impact on these companies, on the private equity industry and ultimately on the wider economy. This would ultimately hurt private equity and infrastructure financing into these companies (and potentially such investment into companies in the broader economy, as without the ability to properly finance investments the private equity and infrastructure model is not sustainable). It would also go against the objectives pursued by the EU with the establishment of a Capital Markets Union and the European Fund for Strategic Investments.

We therefore encourage the ECB to reconsider its approach and to ensure that the definition of '*leveraged transactions*' is properly targeted and does not automatically capture *all* companies backed by private equity funds.

At the same time, the ECB should ensure that all types of loans to infrastructure, and not only those for projects, are exempted from the scope of the definition.

Finally, and following the US example, the Guidance should contain several additional criteria to determine the type of leverage and take into account the actual risk of the loan.

When drafting its guidance, the ECB should also look at the specificities of the European market and bear in mind that the introduction of guidelines for European banks is likely to have a greater impact on European leveraged credit markets than they did in the US, as European borrowers rely more heavily on bank financing than do U.S. companies. The contraction of lending that would ensue could accelerate bank deleveraging and limit the amount of financing available to companies.



It is also very unfortunate that the draft Guidance makes use of an unadjusted definition of EBITDA and does not provide any arguments on the appropriateness of such an approach, especially in light of the serious impact the Guidance could have on the way companies are funded and can fund their growth initiatives over the long-term. As currently drafted, the ECB guidance would impede borrowers' ability to finance business growth.

We would welcome the opportunity to engage with the ECB in order to further explain the view of the industry. We stand ready to provide further information on this subject to assist in ensuring that the ECB definition of '*leveraged transactions*' properly addresses the underlying credit risk of companies across various industries and various ownership structures and that it does not have any adverse consequences on banks' ability to provide financing to businesses.

Contact

Thank you in advance for taking our feedback into account as part of the consultation process. We would be delighted to discuss any of the comments made in this paper in further detail.

For further information, please contact Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.



About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

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